IT 99-0071-GIL 09/08/1999 ALTERNATIVE APPORTIONMENT

General Information Letter: Unsupported statement that separate accounting more accurately reflects business activities in Illinois is insufficient to grant petition to use separate accounting.

September 8, 1999

Dear:

This is in response to your letter dated August 18, 1999, in which you request permission on behalf of xxxxxxxxxxxxxxxxxxxxx to use separate accounting for its Illinois subsidiary. Your letter is in response to our denial of a previous request in IT 99-0067 GIL, dated July 27, 1999. Because your petition again fails to sustain the burden of proof required by 86 Ill. Admin. Code 100.3390, a copy of which is enclosed, we are required to respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter you have stated the following:

> For your review, we are enclosing a copy of the Federal tax return and the xxxxxxxx tax return for xxxxxxxxxxxxxxxxxxxxxxxx (the parent corporation), and an excerpt (Page 5) from its financial statements, which were compiled by this accounting firm. The highlighted statement on the excerpt – "All significant intercompany accounts and transactions have been eliminated" – reinforces the schedules that are attached to the Federal tax return. When reviewing these schedules, please note that there is a column for <u>each</u> subsidiary, as well as a column for the parent company, and a total column.
>
> Each entity of xxxxxxxxxxxxxxxxxxxxx has its own <u>separate accounting</u>; therefore, a reasonable sense of how income (or loss) is generated is reflected for each company <u>and each state.</u> This method reflects a fair and accurate account of each individual entity, without being subject to manipulation or imprecision, and without ignoring any intercompany transfers. Please note that the "Taxable Income" amounts were not affected by intercompany eliminations.
>
> Also, please note that a xxxxxxxx consolidated income tax return was filed, which included the parent company and all wholly-owned subsidiaries, except xxxxxxxxxxxxxxxxx of xxxxxxx IL. The adjustment to Federal taxable income for Illinois operations was $127,135 for non-xxxxxxxx losses, and xxxxxxxx state income taxes were paid on $82,828 before adjustments (see xx. state supplemental schedule "Taxable Income Reconciliation – xx"). It's simple math that tells us that if the $127,135 was taxable income for xxxxxxxx, then this same amount is, in fact, the Illinois losses. Of course, the opposite would also be true – if the Illinois operation has taxable income (in lieu of loss), the amount that is taxable for Illinois would be the amount deducted in arriving at xx taxable income. Certainly, income is not taxable in **<u>both</u>** states - that would be double taxation!
>
> One other point of interest – xxxxxxxxxxxxxxxxx (xxxxxxx IL) began its operations in March, 1998. It's certainly conceivable that an entity would sustain a loss in its first year of operations; however, it should be noted that in future years, the opposite is likely to be true – that the Illinois store will have taxable income. Let's assume for the moment that the 1998 loss of $127,135 is the taxable

income for 1999, and the xxxxxxx entities sustained the losses. Using your three-factor formula, xxxxxxxxxxxx (xxxxx) would not owe any Illinois income tax since the Illinois share of the Federal base income would be a loss of $1,159. (See preliminary computation attached – Part III Base income (loss) allocable to Illinois.) Would you, then, accept the three-factor formula for computing Illinois taxable income – or would you readily accept separate accounting as an alternative allocation?

Mr. Caselton, we feel that the enclosed documents, coupled with the commentary of this letter, should serve as clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income (loss) which is out of all proportion to the business transacted in the state.

Furthermore, in our opinion, when the Illinois three-factor formula is applied to xxxxxxxxxxxxxxxxx (xxxxxxx Illinois), it does not reflect a fair and reasonable sense of how income is generated. "Separate accounting", on the other hand, fairly represents the extent of the entity's business activities in Illinois, and reveals a large defect and unfairness when applying the factors relied upon by the apportionment formula to approximate where business income has been derived.

Response

Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides:

> If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
>
> (2) The exclusion of any one or more factors;
>
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
>
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

While your letter states that you object to the use of the three-factor apportionment formula prescribed in Section 304(a) of the IITA, your analysis indicates that your actual objection is to the use of the combined apportionment method prescribed in Section 304(e) of the IITA. That subsection states:

> Where 2 or more persons are engaged in a unitary business as described in subsection (a)(27) of Section 1501, a part of which is conducted in this State by one or more members of the group, the

> business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method.

Section 1501(a)(27) provides in part:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. . . . Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

When the business activities of a corporation "are integrated with, dependent upon and contribute to" the business activities of one or more related corporations, it becomes very difficult for separate accounting to accurately allocate the taxable income that results from these activities among the various corporations. *See Caterpillar Tractor Co. v. Lenckos,* 84 Ill.2d 102, 115 (1981). Accordingly, combined apportionment is mandated in preference to separate accounting.

The analysis in your letter starts with the contrary presumption -- that separate accounting will accurately allocate business income generated by the activities of a unitary group among the members of that group. Your letter contains no explanation of why that presumption is true, and, absent that presumption, states no basis for reaching a conclusion that combined apportionment fails to accurately reflect the extent of the group's business activities in Illinois, or that separate reporting does more accurately reflect the extent of such activities.

To the contrary, the documents attached to your petition indicate that your separate accounting is inaccurate. For example, you allocate all compensation paid to officers to the parent corporation, even though those officers, as the managers of a centrally-managed unitary business group, presumably perform services for the subsidiaries as well. To the extent it fails to accurately allocate some portion of the officers' compensation to the Illinois subsidiary, your separate accounting overstates the base income attributable to the Illinois subsidiary. Also, if your sourcing of all officer compensation to xxxxxxxx is correct, failing to allocate some of that compensation to the Illinois subsidiary overstates the Illinois payroll factor of that subsidiary.

86 Ill. Adm. Code 100.3390(c) provides that:

> The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden or going forward with

> the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

Because you have failed to present any evidence that combined apportionment fails to accurately reflect the extent of the taxpayer's business activities in Illinois or that separate accounting would accurately reflect the extent of such activities, your petition must be denied.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Sincerely,

Paul S. Caselton
Deputy Chief Counsel -- Income Tax